United Nations DP/2004/46

Executive Board of the United Nations Development Programme and of the United Nations Population Fund

Distr.: General
1 September 2004

Original: English

Second regular session 2004
20 to 24 September 2004, New York
Item 10 of the provisional agenda
United Nations Capital Development Fund

Progress report on options for a future business model for the United Nations Capital Development Fund*

Contents

	Paragraphs	Page
I. Introduction	1-5	2
II. Background	6-11	2
III. A framework for evaluating strategic options for the United Nations Capital Development Fund (UNCDF)	12-22	4
IV. Proposed options for a future strategic niche and business model for UNCDF	23-72	6
A. The changing development context: the MDGs and the role of the private sector	24-33	6
B. Presentation of options	34-72	8
V. Conclusion	73-75	17

* The collection of data required to present the Executive Board with the most current information has delayed submission of the present document.

04-50429 (E) 111004

I. Introduction

1. In response to Executive Board decision 2004/13, this document presents a progress report on the consultation process engaged by the UNDP Administrator to define a future strategic niche and new business model for UNCDF and outlines preliminary lines of thinking.

2. In its decision 2004/13, the Executive Board requested the UNDP Administrator to provide to the Executive Board, at its second regular session in September 2004, a progress report on the options for a future business model for UNCDF. To this end, and in order to inform his proposals, the Administrator established a task force composed of representatives from UNCDF and UNDP, as well as external experts familiar with private sector development (see annex 1 – terms of reference (TOR) of the task force).

3. The task force met several times to establish the guidelines and parameters for the work to be done. It was agreed that the review should be open and forward-looking in nature, and relatively unconstrained by the current activities and portfolio of UNCDF, while seeking to capitalize on the reputation and staff skills that exist within the organization.

4. After intensive work the task force concluded that further technical inputs and consultations with key stakeholders and partners were necessary in order to finalize detailed proposals. In addition, the Administrator considers it important, before more detailed options are formulated, to receive guidance and direction from the Executive Board on the broad strategic approach to be taken by UNCDF as it contemplates its future.

5. The purpose of this document, therefore, is to engage the Board in the consultation process, following which more extensive technical work will be undertaken to develop the preferred option or options for a future strategic niche and business model for UNCDF, detailing their implications for programming and funding arrangements, as well as an assessment of the opportunities, risks and factors for the success of each, and full details concerning implementation goals, modalities and timelines. The present review includes a brief background on the programmatic and financial constraints currently facing UNCDF, proposes a framework for evaluating strategic options, broadly describes the existing strategic opportunities for UNCDF, and outlines the preliminary options for the potential positioning of a revitalized UNCDF.

II. Background

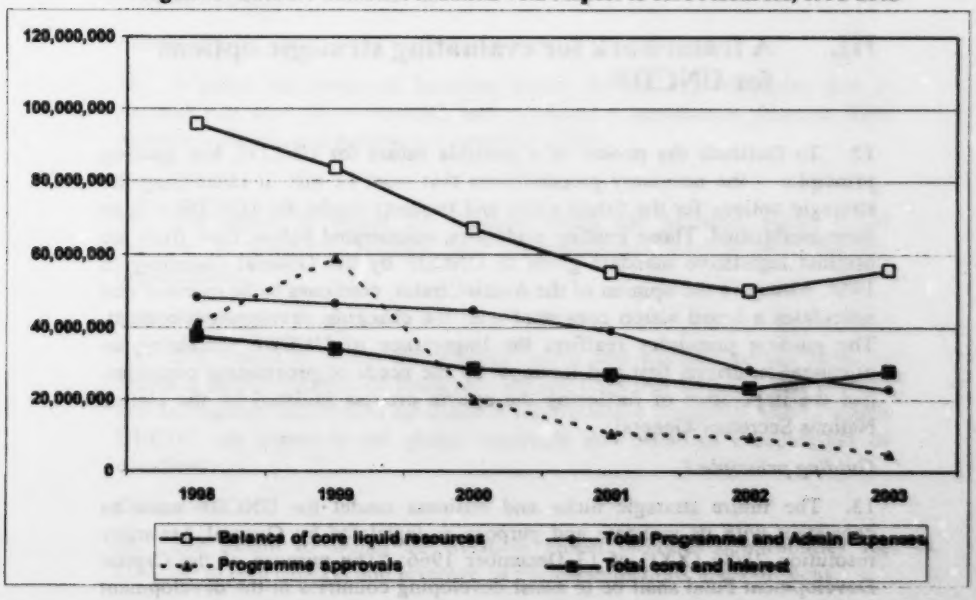
6. In its decision 99/22, the Executive Board requested that an independent evaluation of the impact of UNCDF programmes and projects be conducted. That evaluation, called the Independent Impact Assessment (IIA), was looking for ways and means by which, 38 years after its founding, the organization could establish itself as a global leader in its areas of activity. Questions have also been raised on the complementarity, and potential for exploiting synergies, between its two main focus areas: decentralization and local

governance, and microfinance initiatives. Several stakeholders have pointed out the overlap between the local governance mandates of UNCDF and other United Nations agencies, including UNDP, and the inefficiencies and confusion that this engenders. Finally, as a concrete reminder that UNCDF needs to re-examine its strategic positioning, contributions to the organization have declined over the past several years, putting its financial viability into question.

7. The IIA confirmed that the Fund has contributed to significant results through both its microfinance and local governance programmes in poverty reduction, policy impact, and replication of its projects by donors. Despite the positive findings on UNCDF development effectiveness and performance, however, the IIA questioned its existing business model, which was based on the key assumption that good results and an efficient, effective organization would lead to increased donor support and sustained core funding. The IIA judged that assumption to be flawed; since despite good results, core contributions have dwindled. This diminution has been only partly offset by increases in non-core resources, which are, moreover, unpredictable. The findings of the IIA are presented in Executive Board document DP/2004/18.

8. As figure 1 demonstrates, the trend in the UNCDF financial situation for core resources between 1998 and 2003 has been downward, and programme approvals and expenditures were reduced significantly to ensure the financial integrity of the Fund. The figure shows clearly the dramatic drop of core resources and the level of programme approvals in the period under review. It is also anticipated that the slight improvement reached in 2003 would again dip in 2004, requiring further downward adjustment of expenditures and approvals for following years unless new revenue streams are found.

Figure 1. UNCDF financial situation with respect to core resources, 1998-2003



A brief history of UNCDF and the major milestones in its evolution since its founding in 1966 are contained in Annex 2.

9. Given the continued failure to meet the core resource target called for by the Executive Board (in its decision 2002/26) of $30 million a year to support the work of UNCDF, it is clear that the current situation is not sustainable, and there is an urgent need to review the business model and make appropriate adjustments.

10. Apart from the financial crisis, the Administrator believes that the sustainability of the programmatic focus and approach of UNCDF, based as it is on the twin pillars of microfinance and local governance, is in question. On the one hand the microfinance portfolio, which appears to have potential if developed as a strategic niche for UNCDF, is relatively small in scale and impact, and has not established UNCDF as a global leader in the field. Furthermore, the grant model on which UNCDF relies to fund its activities has severely limited the potential for UNCDF to upscale its microfinance efforts in any meaningful way. On the other hand, the local governance programme (which is also reliant on grant funding) faces serious competition from other players in the market, including UNDP. Consequently, there appears to be little clear comparative advantage or justification for UNCDF to independently pursue programmes in local governance that clearly overlap with others.

11. The IIA report made several recommendations, the second of which called for the analysis, review and development of a new business model and appropriate corporate governance arrangements to support it, leading directly to Executive Board decision 2004/13 and the review exercise referred to in paragraph 2 above. For the reasons mentioned above, the Administrator fully supports this review.

III. A framework for evaluating strategic options for UNCDF

12. To facilitate the review of a possible future for UNCDF, key guiding principles – the necessary preconditions that must be met in identifying the strategic options for the future niche and business model for UNCDF – have been established. Those guiding principles, enumerated below, flow from the original legislative mandate given to UNCDF by the General Assembly in 1966, which, in the opinion of the Administrator, continues to be relevant and articulates a broad vision consistent with the changing development context. The guiding principles reaffirm the importance of UNCDF remaining an organization driven first and foremost by the needs of programme countries, and the imperative of furthering the reform process initiated by the United Nations Secretary-General.

Guiding principle 1

13. The future strategic niche and business model for UNCDF must be consistent with its mandate and purpose as legislated by General Assembly resolution 21/86 (XXI) of 13 December 1966: "The purpose of the Capital Development Fund shall be to assist developing countries in the development

of their economies by *supplementing existing sources of capital assistance by means of grants and loans, particularly long-term loans made free of interest or at low interest rates. Such assistance shall be directed towards the achievements of the accelerated and self-sustained growth of the economies of those countries and shall be oriented towards the diversification of their economies, with due regard to the need for industrial development as a basis for economic and social progress.*" (Italics added.)

Guiding Principle 2

14. The future strategic niche and business model for UNCDF must be consistent with the vision and goals of the Millennium Development Goals (MDGs) and must demonstrably contribute to their attainment, since they represent the development aspirations and consensus of the global community, donor and programme countries alike.

Guiding Principle 3

15. UNCDF will remain a country-driven organization, reflecting the primacy and centrality of country priorities and needs.

Guiding Principle 4

16. The future strategic niche and business model for UNCDF must further the goals and objectives of the reform process initiated by the United Nations Secretary-General by complementing in a synergistic way the mandates and activities of other United Nations agencies, funds and programmes engaged in development interventions.

17. Apart from the above guiding principles, four criteria are presented below, each of which establish desirable benchmarks for a future niche and business model for UNCDF. The criteria are considered important in the process of identifying and narrowing the range of possible options for a more detailed analysis.

Criterion 1

18. Whether the proposed business model defines a clear niche that is focused and easy to understand, and promises a sustainable demand from partners – donors and programme countries alike.

Criterion 2

19. The extent to which the strategic niche and business model could promise an adequate, reliable, and self-sustainable funding base for the organization.

Criterion 3

20. The extent to which the strategic niche and business model helps to define a unique product or integrated service lines that UNCDF can provide that is required and valued by donor and programme countries, and in which UNCDF can aspire to set global standards and establish a reputation of excellence.

Criterion 4

21. The extent to which the business model provides opportunities for UNCDF to be a catalyst and leverage its partnerships in its areas of focus.

22. The above guiding principles and criteria together constitute an evaluative framework for the development and consideration of the options outlined in the next section. Using this framework, it has been possible to identify key strategic objectives and an appropriate possible positioning that could provide legitimacy for a new dialogue with the Board on the future of UNCDF based on existing strengths and excellent opportunity offered by two major events, namely, the report of the Commission on the Private Sector and Development, and the United Nations International Year of Microcredit (2005).

IV. Proposed options for a future strategic niche and business model for UNCDF

23. The Administrator considers that the overall goal of UNCDF – poverty reduction – remains relevant and central to its mission, as does its focus on the least developed countries (LDCs). In addition, the Fund can, and should, build on its experience in providing basic infrastructure and financial services to the poor through strengthened local authorities and the building of inclusive financial sectors.

A. The changing development context: the MDGs and the role of the private sector

24. Two major trends in the development marketplace directly influence the selection of the future strategic niche for UNCDF. First, world leaders convened at the Millennium Summit in September 2000 and agreed on a Millennium Declaration and Millennium Development Goals, most of which are to be achieved by 2015. The MDGs comprise a framework for furthering human development and alleviating poverty that enjoys the political commitment of the international community. Second, there is increasing recognition that the private sector and entrepreneurship are key to reducing poverty, evidenced by the strong links between private investment, economic growth and poverty reduction. Most recently, the role of the private sector in meeting the challenge of poverty, and the specific actions and approaches that need to be taken by the international community, have been the subject of a report to the Secretary-General entitled *Unleashing Entrepreneurship: Making Business Work for the Poor*. Taken together, these two developments have significantly altered the development context and strategic environment for UNCDF, and may offer pointers in identifying a future niche for UNCDF that would make it both programmatically relevant and financially sustainable.

25. It is significant that the MDGs codify and crystallize in very specific targets, for the first time, the goals of human development and poverty eradication that are the overall policy goals of UNCDF. The goals are the product of a series of United Nations conferences held over the past decade – culminating in the Millennium Declaration, which was signed by 189 countries – and lie at the heart of the Monterrey Consensus and the Johannesburg Plan of Implementation.

26. Since 1999, UNCDF has oriented its capital investments and technical support towards microfinance and local development, two areas that are crucial for the achievement of the MDGs. This has been done in strong complementarity with UNDP. In joint programmes in more than 20 countries UNCDF has matched capital support and specialized expertise with UNDP technical assistance, thus contributing directly to several of the UNDP service lines. Most importantly, this package of capacity building, coupled with investment interventions, has reinforced the effectiveness of the United Nations in support of the achievement of the MDGs. Opportunities exist for UNCDF to expand this type of joint programming not only with UNDP, but also in wider partnerships.

27. The Human Development Report 2003 classified all the LDCs as 'top priority' countries where urgent action is needed to meet the MDGs. UNCDF, which serves the LDCs first and foremost, is well placed to reinforce United Nations action in precisely these top priority countries, where the MDGs run the highest risk of not being met. The detailed knowledge acquired by UNCDF through its work in LDCs at the local level could be tapped to reinforce United Nations efforts to localize the MDGs. UNCDF experience with small-scale investments in water supply and natural resource management could reinforce United Nations implementation of key recommendations of the World Summit on Sustainable Development in such areas as renewable energy and water and sanitation.

28. The MDGs provide an important operating and accountability point of reference, as well as a guiding framework, for all development practitioners, including UNCDF. The Executive Board, in its decision 2004/13, reaffirmed the role that UNCDF can play in achieving the MDGs at the country level.

29. Over the past two decades, development strategies have reflected the belief that sustainable economic growth in developing countries depends, *inter alia*, on a vibrant private sector. That conviction, however, has been largely reflected in development strategies by their attention to the adoption of pro-private sector macro policies and the creation of an 'enabling environment' for the private economic activity – stable macro-economic conditions, contract enforcement, effective regulatory institutions and the like.

30. Only in more recent years has a consensus developed on the critical role of private sector enterprises in reducing poverty by contributing to economic growth and job creation. Private enterprise throughout the developing world delivers, or participates in delivering, through public-private partnerships, crucial social services and products – including those related to safe water, power, roads, telecommunications, education and health. Finally, experience has shown that a vibrant private sector, active in economic life and decision making, brings new ideas, energy and innovation to the entire development process, and is a good vehicle for enabling participatory development.

31. *Unleashing Entrepreneurship: Making Business Work for the Poor* highlights the role of the private sector in the development process. The report's core message is simple and powerful: we will not achieve the MDGs unless we engage the private sector as a whole and unleash the power of domestic entrepreneurship. The message is grounded in the reality that the bulk of the poor live in the private sector – indeed, they *are* the private sector. Engagement with the private sector needs to leverage both technical capabilities and finance.

32. For all these reasons, there is renewed focus on actions that can be taken to support micro and small and medium enterprises directly, especially where there is good potential for job creation or where private enterprise can fill gaps in the provision of basic social services. Consistent with the guiding principles described in the previous section, the Administrator believes that UNCDF should more proactively engage and support the development of the private sector, building on its work with local private sector actors and developing new, international private sector partnerships.

33. Clearly, the adoption of the MDGs as an agenda for human development and the role of private enterprise and entrepreneurship in development are fundamentally linked, to the extent that both aim at empowering people by increasing the choices available to them, thus contributing to the reduction of poverty. The Millennium Declaration resolves "to develop strong partnerships with the private sector and with civil society" and provide a clear mandate to development agencies to harness the resources and energy of the private sector in order to achieve the MDGs and alleviate poverty. The Executive Board, in its decision 2004/13, in addition to reaffirming the role that UNCDF can play in achieving the MDGs, specifically requested the Administrator to examine ways in which UNCDF can contribute to pro-poor local private sector development.

B. Presentation of options

34. It should be emphasized that the option of maintaining the status quo is simply not a viable option for the future of UNCDF, as indicated by the IIA. Taking into account the inputs of the task force, the UNDP Administrator has identified two viable options for a new strategic niche, which take into account the evaluative framework described in section III above. The first option outlines a "conservative" strategy, based simply on an expansion of current UNCDF activities, but focusing on one of the two programme areas as a niche. The second approach is more innovative, calling for a redefined UNCDF that seeks to act as a channel for the funding of private capital to achieve the MDGs. These two options are presented below, with a brief presentation and discussion of each option taking into consideration preliminary analysis of the situation, the comparative advantage, institutional arrangements and implications.

Option 1 – ODA-based model: A UNCDF specialized in retail microfinance funded by voluntary contributions, migrating its local governance programmes to UNDP

35. Given the current, and essentially stagnant, level of funding received by UNCDF, as well as the concerns that have been expressed about its existing two programme areas, microfinance and local governance (described in paragraph 5), one option for UNCDF would be to select one of these areas as a programmatic niche, thus sharpening its focus and increasing its visibility and impact.

36. This option would require UNCDF to specialize in the area of microfinance and the development of inclusive financial sectors, phasing out its programmes and activities in the area of local governance as they are

transferred into a new unit of UNDP: the Centre for Local Development (CLD). It is envisioned that the programme strategy and nature of the current microfinance portfolio UNCDF would not be changed, but would be expanded and scaled up – depending on resource availability – to a larger number of programme countries so as to increase coverage and impact. Under this option, UNCDF would continue to rely on voluntary contributions from member countries to finance its activities, as at present.

Situation analysis

37. World leaders have pledged to achieve the MDGs, including the overarching goal of cutting absolute poverty in half, by 2015. Comprehensive impact studies have demonstrated that microfinance is an effective tool for poverty reduction. The Report of the Commission on the Private Sector and Development also stresses the importance of expanding access to microfinance for entrepreneurs and is supported by the Action Plan recently approved by the G8, which underscores the vital role of available microfinance and financial services.

38. The Consultative Group to Assist the Poor (CGAP), a consortium of 28 public and private development agencies working together to expand access to financial services for the poor has found that global demand for basic financial services stands at an estimated 1 billion people. The Microfinance Information eXchange (MIX) estimates current coverage at only 10 per cent of this potential market, and there is a general consensus that many people and businesses currently excluded from financial services are actually bankable. At present, only around two per cent of an estimated ten to fifteen thousand microfinance operations and institutions worldwide are considered to operate in a professional and fully sustainable manner. There is a general consensus among key players in the field of microfinance that, in order to grow and reach its full potential and have a lasting impact, microfinance should become an integral part of the formal financial system.

39. Three main categories of constraints need to be addressed for the financial sector to be able to respond to the existing demand in a sustainable manner:

(a) The lack of an enabling policy, legal and regulatory environment;
(b) The lack of institutional and human capacity in financial institutions to deliver these services; and
(c) The lack of capacity on the part of people and businesses to demonstrate that they are bankable.

Objectives, policy and strategy for implementation

40. Under this option, the primary objectives of UNCDF would be to increase sustainable access to financial services for poor and low-income people and to promote, apply and advocate sound microfinance principles and practices. In pursuing those objectives, UNCDF would focus its activities on supporting the development of young and emerging microfinance sectors in partnership with other donors and through the UNDP country office network.

41. UNCDF resources would be invested in developing countries, first and foremost in LDCs, but also in non-LDCs. UNCDF investments, managerial, technical and advisory services would give priority to supporting countries and institutions with a demonstrated commitment to creating and promoting the

sustainable provision of financial services for poor and low-income people as an integrated part of the formal, commercial financial system.

42. Under this option, UNCDF would operate globally as a policy and technical advisor on microfinance to UNDP and would advocate the application of sound principles and practices of microfinance throughout the UNDP group.

43. At the country level, UNCDF would support countries to formulate national policies and actions plans to address the constraints that hamper the development of the microfinance sector. As a UN agency, UNCDF, in collaboration with UNDP is well positioned to bring together key stakeholders like central banks, commercial banks, microfinance institutions, bi-lateral and multi-lateral donors to formulate and implement national action plans to build inclusive financial sectors. UNCDF has already started to implement this strategy in 2003. To invest in building the capacity and capital base of retail microfinance operations, UNCDF would support a range of microfinance institutions to build their capacity to provide financial services in a sustainable manner and by strengthening their capital base through grants and loans. Through an expansion of the MicroStart programme, UNCDF would continue partnering with UNDP. Preliminary findings from an external review of the entire UNDP global microfinance portfolio by CGAP indicate that MicroStart is the most successful programme in the entire UNDP portfolio and that the design and technical management of UNCDF are key factors behind this success.

Comparative advantage

44. UNCDF is well positioned to support the development of microfinance operations and microfinance sectors. It has a specialized team of microfinance experts both at head office and in the field and enjoys close collaboration with UNDP country offices. The CGAP Donor Peer Review noted that "UNDP has privileged access to the excellent technical services of the internationally recognized, dedicated microfinance unit of UNCDF. UNDP staff that have worked with UNCDF/SUM uniformly praise its technical competence and exceptional service". In partnership with UNDP, the potential of UNCDF to support the development of financial services for poor and low-income people is high, given its network, neutrality and mandate.

45. At present, UNCDF specializes in supporting the development of sustainable microfinance sectors in LDCs, including in post-conflict settings, by building capacity at the retail level and assisting in the formulation of sound microfinance policies and action plans at the national level. This experience lends itself to replication across a wider range of countries. UNCDF acts as the policy and technical advisor for UNDP, providing training, technical and policy advice and support for programme management at the central, regional and country level.

46. A UNCDF specializing in microfinance would be the only United Nations organization focused solely on microfinance with the ability to make both loans and grants directly to the private sector. The ability to recover capital is a key advantage in working with the private sector.

Institutional arrangements and implications

47. UNCDF already has a team of microfinance experts providing technical and programming services to its own, and UNDP, programmes as well as training to UNDP staff. The technical expert team would continue to be supported by the existing evaluation unit, a finance unit, a human resource unit, and a communication unit. In regions where UNCDF has a critical mass of programmes, the services would be delivered by a decentralized unit, located in the nearest UNDP Regional Centre. Such units are being established in Dakar and Pretoria this year.

48. As indicated earlier, existing programmes relating to local governance would be transferred to the CLD. The CLD could become the investment arm of UNDP and support several of its services lines, focusing on LDCs as well as on areas of non-LDCs where the 'MDG gap' is greatest. Over the last decade, UNCDF experience has shown that linking decentralization reforms to poverty reduction and providing investment resources to support decentralized planning and financing of local development can be a powerful way of building hands-on local capacities and credibly piloting policy innovations for wider replication.

49. The establishment of the CLD is not likely to require the creation of new posts and most of the current staff (a mix of programme managers, programme officers, and technical experts) of the UNCDF Local Development Unit would be re-assigned to the CLD. In order to bring services closer to programme countries, most staff would be out-posted in four regions (West Africa, East-Southern Africa, Asia, and the Arab States).

50. The proposed institutional setup takes into account the principles of United Nations reform by complementing in a synergistic way the mandate and activities of UNDP. Fully integrated into UNDP, the CLD would be a distinct unit, with a specific capacity building mandate. However, it would enjoy the degree of management flexibility and identity necessary to ensure the professional management of its operations and facilitate continued core and non-core resource mobilization. Existing UNDP centres of excellence (such as the Oslo Governance Centre and the Drylands Development Centre) offer a possible organizational model.

Financing model and resource requirements

51. Resources required by UNCDF its microfinance programme grants, capitalization of the loan fund, and operational expenses would be covered by voluntary contributions from donors. It is estimated that the total funding requirement per annum would be around $30 million. The cost of technical advisory services to UNDP would be reimbursed by UNDP headquarters and UNDP country programmes.

Opportunities and risks

52. The launch of the International Year of Microcredit (2005) will provide an opportunity to increase the visibility of UNCDF microfinance operations, highlight the contribution of microfinance to the MDGs, and attract new sources of funding, including international commercial banks. A key activity is the *Blue Book* being prepared by UNCDF, which will highlight for programme countries best practices in building inclusive financial sectors.

53. However, the financial viability of the organization under the current funding structure – which would be continued under this option – would remain uncertain, with revenues from loan funding not likely to cover costs. If resources remain at their current level, UNCDF is likely to remain marginal, with little possibility of emerging as a leader in its field or contributing in meaningful ways to global development efforts.

Option 2 – Private sector-based model: A UNCDF specialized in channeling and utilizing private capital for high social impact investments in support of the MDGs, migrating its local governance programmes to UNDP

54. This option is grounded in a vision for a future UNCDF that, in close partnership with UNDP, would specialize in leveraging significant, affordable financing from global capital markets to fund high social impact investments in developing countries. That vision is driven by the rationale that mobilizing the resources needed to achieve the MDGs will require leveraging the resources of both the private and public sectors. Significant pools of untapped private funds can be attracted to invest in enterprises that generate positive social impact, even with a longer time horizon, provided that commercial returns can be reasonably assured.

55. Accordingly, this option calls for a redefined UNCDF that would intermediate between the sources and uses of investment capital, given its wide experience and proven expertise in microfinance and building inclusive financial sectors. Under this option, focusing on the identification of high-impact investment opportunities, UNCDF would help establish preconditions to attract and channel private capital to fund such opportunities. Playing a unique role in channelling private funds to socially productive and commercially viable uses, UNCDF could, under this option, create a position of global leadership for itself. UNCDF could catalyse international public-private partnerships to provide capital to the pro-poor local private sector. In contrast with option 1, under this option UNCDF only a modest amount of recurrent funding to meet its operational expenses.

Situation analysis and description

56. One important area where the contribution of the private sector is now considered crucial to the realization of international development goals is that of development financing. The International Conference on Financing for Development, held in Monterrey in March 2002, concluded that there were likely to be dramatic shortfalls in the available resources required to achieve the MDGs by 2015. As *Unleashing Entrepreneurship: Making Business Work for the Poor* points out, the potential for domestic private investment remains largely untapped, and – when the value of informal assets is taken into account – represents an underutilized investment pool that may be several times larger than current foreign direct investment or portfolio flows. What is required, and what is frequently lacking, are domestic financial institutions that can efficiently manage risk, and channel and allocate capital to productive investments.

57. The Commission on Private Sector and Development further concludes that, more than just as a source of development finance, the private sector must be tapped for the organizational and managerial capabilities it can provide in the service of development. In order for this to happen, the private

sector must be involved in funding financially sustainable opportunities, driven by the discipline of market principles.

58. Under this option the programmes and activities of UNCDF in the area of local development would be transferred to UNDP, possibly as part of the establishment of a CLD, as described in the discussion of option 1 above.

Objectives, policy and strategy for implementation

59. Under this option, as indicated above, UNCDF would focus on channelling private capital to developing countries, with the clear goal of maximizing this flow. In so doing, it would need to perform the following functions:

(a) Identify potential high-impact, socially productive and commercially viable investments attractive to private sector capital. While the range of possible investments could include, *inter alia*, microfinance, the financing of small and medium enterprises and micro-infrastructure financing, two specific criteria would be used to evaluate possible investments: *first*, whether channelling private sector capital to the investment would contribute meaningfully to the achievement of the MDGs; and *second*, whether the investments would likely produce returns adequate to attract and sustain private capital. UNCDF would need to establish internal analytical capacities to answer these questions.

(b) Develop, as necessary, the identified investment opportunities to the point where they are more aligned to the needs and interests of potential private lenders. This could include the provision of early technical assistance or seed funding until an opportunity matured; active support in dealing with policy or operational constraints; or working to reduce risk and volatility for investors by negotiating public subsidies or financial restructuring. One possibility would be for UNCDF to develop new financial instruments, such as pooled investment funds, that could be attractive to investors. Further study is required on other possible innovative ways in which UNCDF could work to strengthen the commercial attractiveness of its investment opportunities. This function would require seeking out and engaging private sector investors, understanding their needs, and helping to shape, package and promote potential opportunities based on a clear understanding of those needs.

(c) Serve as the instrument to channel private funds to the opportunities identified and developed. In so doing, UNCDF would not identify individual enterprises or projects as investment opportunities. Its strategy would be to fund deserving projects through wholesale public or private financial intermediaries dealing directly with the ultimate borrower.

60. As indicated above, the range of investment opportunities that could be funded through UNCDF is wide, would depend on local conditions and needs, and would be subject to the evaluative criteria described in the previous paragraph. The investment decisions of UNCDF under this option would not assume any particular sectoral or client-based focus and UNCDF would not seek to prescribe or limit the search for viable social investments. However, some clear possibilities exist.

61. Building on its extensive experience and expertise, one area of involvement could be *wholesale microfinance*. The Consultative Group to

Assist the Poor (CGAP), a consortium of 28 public and private development agencies working together to expand access to financial services for the poor, has found that global demand for basic financial services stands at an estimated one billion people, only 10 per cent of whom are currently being covered. At present, only around two per cent of an estimated ten to fifteen thousand microfinance operations and institutions worldwide are considered to operate in a professional and fully sustainable manner. Furthermore, if professionally delivered according to commercial principles, microfinance has the ability to be profitable and leverage additional commercial funds. UNCDF enjoys particular comparative advantages within the United Nations system to work in this area:

(a) UNCDF has both grants and loans amongst its financial instruments and is able to work directly with the private sector;
(b) The entry point for UNCDF activities – young and emerging markets – has the greatest potential for growth. The majority of these markets are LDCs;
(c) A UNCDF focused solely on building inclusive financial sectors would capitalize on these strengths.

62. Another focus area could be investments directly related to *the achievement of MDG targets*. The provision of quality financial services has proved to be an effective way of promoting the MDGs but more could be done. UNCDF would seek not only to build on achievements to date (in areas such as poverty reduction and access to education) but also to broaden the range and impact of its financial services and investments to include the environment, energy services, housing, and water supply and sanitation. The objective would be to identify partner enterprises and products having the greatest potential in terms of return on social investment and profitability. This would require exploring current models, in collaboration with other United Nations organizations, to see what could be replicated and scaled up in partnership with the private sector. Carefully designed financial products targeting specific MDGs could break new ground by piloting new approaches and developing new partnerships around appropriate financial products. Few such proven and financially viable products currently exist, however, and they would have to be developed.

63. A third possible focus area for UNCDF investment programmes could be *the development of micro, small and medium-sized enterprises (MSMEs)*. While there is an abundance of microcredit institutions targetting micro and subsistence enterprises, an underserved niche clearly exists to serve the credit needs of small and medium-sized enterprises. UNCDF could consider adding this client focus, since small and medium-sized enterprises are a better engine of employment for the very poor and vulnerable who may not be able to take on credit or debt for self-employment, and other poor people who need wage employment. Furthermore, adding small and medium-sized enterprises offer greater scope for direct impact on the achievement of MDG targets, many of which require a higher critical mass of investment. UNCDF could target its lending to financial institutions engaged in MSME finance (such as loans, leasing and equity), which would also require the provision of non-financial, business development services to SMEs. As UNCDF would not provide non-financial services directly, to ensure a strong UNCDF portfolio, UNCDF would need strategic partnerships with other institutions (United Nations organizations, the World Bank group and others, including the private sector)

that provide these business development services. While the potential size of the market for loans to MSMEs is large, existing funds tend to focus on more mature markets. Hence the experience of UNCDF in young, emerging markets and in capacity building could give it a strong brokerage role in creating investment opportunities.

64. Under this option, private capital would be invested in developing countries, low-income countries and, first and foremost, in LDCs. UNCDF investments and its managerial, technical and advisory services would give priority to supporting countries and institutions with a demonstrated commitment to creating and promoting the sustainable provision of financial services for poor and low-income people as an integrated part of the formal, commercial financial system. UNCDF would continue to act as a global policy advisor to UNDP in microfinance.

Comparative advantage

65. Building on its experience in microfinance, UNCDF is well positioned to support the development of investment operations. It already has a specialized team of experts, both at the head office and in the field, with wide experience and proven expertise, and enjoys close collaboration with UNDP country offices. UNCDF has considerable experience in the identification and lead funding of a range of social investment opportunities, especially in LDCs, as well as information on the actors, needs and costing of social service delivery that would be particularly valuable under this option. Finally, UNCDF, along with UNDP, has unique strengths in addressing the systemic and policy issues required to create the preconditions for private funding of social investments.

Key factors for success

66. The successful implementation of this option would be crucially dependent on the ability of UNCDF to inspire confidence among private capital markets in its ability to identify attractive, commercially viable investments in developing countries that have a potential of yielding reasonable returns. This, in turn, would require the organization to develop capacities to be professionally rigorous, active and outward oriented in engaging with the investment community, understanding and responding to their needs by crafting investment products and services that would increase the flow of capital to investments with high social impact. As indicated earlier, UNCDF would need to engage in a range of activities to prepare the ground for private investments, providing of early technical assistance, seed funding, smoothing policy or operational constraints, negotiating public subsidies, and otherwise reducing risk and volatility for investors. Apart from the acquisition or development of new technical skills and capacities to serve the new philosophy and approach embodied in this option, the management of changes in attitude and the organizational culture of UNCDF would be critical.

Institutional arrangements and implications

67. The leadership and management responsibility of UNCDF operations would rest with a professional fund manager with experience in the management of private investment funds. Successful implementation of this option would also call for the development of the skills and capacities indicated in the above paragraph. The comparative advantage of UNCDF lies in capitalizing on new investment opportunities, and for this a capacity building facility is required that, together with UNDP, could research

investment opportunities, provide capacity building inputs, help to analyse constraints in the enabling environment, and help develop investment opportunities as required.

68. It is envisaged that the capacity building facility would consist of a team of experts that would also provide technical and programming services to its joint programmes with UNDP. Both teams would be supported, to the extent possible, by UNDP central service units. In regions where UNCDF has a critical mass of programmes or funding activities, services would be delivered by a decentralized unit located in the nearest UNDP regional center.

Financing model and resource requirements

69. To ensure its financial viability, the recurrent operational expenses for UNCDF would be financed by modest multi-year funding commitments from donors and by reimbursement for services provided to UNDP. It is envisaged that UNCDF would require ongoing annual funding of $10-15 million to meet ongoing operational costs. Outside this funding requirement, the goal would be to leverage as much private capital as possible to productive investments.

70. Under this option, the primary role of UNCDF would be to use the assets, resources and platform of the organization to channel private sector capital to high-impact uses in support of the MDGs. The organization would not invest funds of its own, an option that would require a much larger capital base than is being envisaged at present. However, should there be sufficient donor interest, UNCDF might, at a later stage, consider raising resources independently to manage its own fund and make investments of its own.

Opportunities and risks

71. This option provides an opportunity to leverage private capital in support of poverty reduction while capitalizing on the traditional strengths and wide experience of UNCDF. It holds the promise of demonstrating real and tangible impact in a strategic niche that is currently underserved, thereby establishing UNCDF as a global leader and a centre of excellence in building inclusive financial sectors. It is expected that a strong base for partnerships with other organizations would be created, not only within the United Nations system (the United Nations Industrial Development Organization, the International Labour Organization and others), but also other development finance agencies such as the International Finance Corporation, the World Bank, regional development banks, and private capital funds that could be called to take over once the opportunities promoted by UNCDF had matured enough to attract external investment. Finally, by providing UNCDF with greater visibility, it would contribute to mobilizing additional non-core resources, putting the organization on the path to financial sustainability.

72. The launch of the International Year of Microcredit (2005) is an excellent opportunity to increase the visibility of UNCDF microfinance operations, highlight the contribution of microfinance to the MDGs, and attract new sources of funding, including international commercial banks. Among the risks, donors might not be willing to provide a capital base for the fund, and development banks and the private sector might not be willing to invest in the fund.

V. Conclusion

73. This document has presented a report on the work in progress, with a broad description of two options for a future strategic niche and business model for UNCDF, and an evaluative framework setting the key guiding principles and strategic criteria on the basis of which the proposed options have been suggested. It is hoped that the application of this framework, together with in-depth discussion of the various options, will facilitate sharing with the Executive Board the preliminary thinking on strategic positioning for a revitalized UNCDF. In this regard, the Administrator would like to engage the Executive Board in the consultation process and seek its guidance on the proposed options.

74. It is the considered view of the Administrator that option 2 embodies a more innovative approach and a longer-term vision than does option 1, calling for more radical adjustments in the philosophy, approach and even organizational culture of UNCDF. While driven by global changes in the development world, with the aim of bringing together the public and private sectors in order to achieve the MDGs, it also builds on the extensive experience and knowledge that UNCDF has accumulated over the years, working directly with the poor and providing basic infrastructure and funds to support local economies.

75. Subsequent to guidance from the Executive Board, it is envisaged that UNDP, through the task force and others, will develop implementation plans for the preferred new business model for UNCDF and revert at a later session with details including, *inter alia*, the structure, staffing, resourcing implications, implications for partnership building, governance issues, the relationship with UNDP, transitional issues, and timelines.